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# Chinalco and Rio Tinto: A Long March for China's National Champions

Shujie Yao and Dylan Sutherland

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The global financial crisis has left many Western transnational corporations (TNCs) severely weakened, presenting Chinese large state-owned enterprises with an unprecedented opportunity to “go global” through acquisitions. The US\$19.5 billion deal of the Aluminium Corporation of China (Chinalco) for Rio Tinto (Rio) this year, although scrapped by Rio on 5 June 2009, serves as an interesting illustrative case in this regard. At face value, Chinalco's pursuit of Rio, as with the China National Offshore Oil Corporation (CNOOC)'s failed bid for the big US oil company Unocal in 2005, appears to be mainly about China securing natural resources. It also, however, represents the intensifying efforts of China's national champions to undertake their own long march to catch up with the world's leading TNCs. Despite Chinalco's aborted attempt, China's desire to acquire foreign assets will not diminish; instead, its future forays may become more tactical and aggressive.<sup>1</sup>

## The Chinalco–Rio Deal

Rapid growth over three decades has made China thirsty for oil and raw materials. In a drive to secure a stable and cost-effective supply, policy makers have encouraged national champions to buy or heavily invest in foreign companies, including gigantic TNCs such as Rio, the world's second-largest mining company. In February 2008, Chinalco paid US\$14 billion to buy a 9 per cent stake in Rio (see Table 1). The purchase, representing China's largest foreign investment ever, effectively killed off BHP's bold US\$147 billion move for Rio.

This was not, however, the end of the story. Chinalco pencilled in a further US\$19.5 billion strategic partnership in February 2009 with Rio, as the latter was desperate for a further capital injection to pay off its huge debts, incurred after buying Canada's Alcan in 2007.

Chinalco and China, seemingly, had got what it wanted. It had done so, moreover, through a cleverly orchestrated set of moves. Yet, during the long FIRB (Australia's Federal Investment Review Board) review process, Rio's share price recovered and shareholders started to question the terms Chinalco was

1 Shujie Yao, “China will learn from Chinalco's failed deal,” *Financial Times*, 8 June 2009, p. 11.

Table 1: **Chinalco, Rio Tinto and BHP Billiton’s Struggle for Control**

Important dates	Event
October 2007	Rio Tinto bought Alcan for US\$38.6 billion, incurring US\$34 billion of debts
November 2007	BHP attempted to buy Rio on a 3:1 all-share swap
February 2008	Chinalco with the US’s Alcoa invested US\$14 billion to buy 9 per cent of Rio’s shares
August 2008	Chinalco raised its stake in Rio to 11 per cent
November 2008	BHP abandoned its plans to buy Rio due to Chinalco’s intervention
February 2009	Chinalco agreed to invest another US\$19.5 billion in Rio: US\$12.3 billion for minority stakes in iron ore, copper and aluminium assets and US\$7.2 billion for convertible bonds to take its equity stake in Rio to 18 per cent and two non-executive seats in Rio’s board
5 June 2009	Rio unilaterally abandoned its deal with Chinalco and proposed an alternative, to raise US\$15.2 billion through right issues and US\$5.8 billion from BHP Billiton by forming a joint venture with the latter in western Australia

offering. In particular, the dilution of existing shareholders’ equity caused consternation. Shareholders, moreover, increasingly questioned whether it made sense to ally with the single largest customer – a Chinese company. Alternatively, would it not make more sense, by merging with BHP Billiton in the all-important iron ore reserves in the Pilbara region of Western Australia, to instead bleed this helpless customer dry by forming a global duopoly in sea-borne iron ore? Huge cost savings, estimated at around US\$10 billion, through the sharing of rail and port infrastructure, could also be achieved. The combination of the Pilbara assets in a single joint venture held a powerful industrial and market logic.

Chinalco came close to securing a good deal for China and itself. As the FIRB review dragged on, however, prospects for global commodity markets improved dramatically.<sup>2</sup> By 5 June 2009 the deal finally ran aground. Rio unilaterally pulled the plug, just one week before a FIRB meeting to decide on the deal. Rio’s actions have greatly angered China’s leaders. As a result, on 5 July the Shanghai Security Bureau detained Stern Hu (a Chinese national with Australian citizenship) and three other Chinese staff working in Rio’s Shanghai office. On 12 August they were formally arrested and may be charged with using improper means to obtain commercial secrets of China’s iron and steel industry.

Chinalco’s initial offer, made at the bottom of the market, was rejected – even at the expense of a US\$195 million escape fine – as the conversion rate on its convertible bond looked less and less appealing to shareholders. Instead, a rights issue for US\$15.2 billion and a joint venture in the Pilbara mines with BHP, netting Rio US\$5.8 billion, was proposed. This would clear its short-term debts

2 Ironically, this was in part driven by China’s own massive stimulus packages.

incurred in the Alcan misadventure. Conveniently, it would also greatly strengthen its bargaining position with its major customers – including Chinese steel makers.

### China's National Development Strategy

Chinalco's bid for Rio must be seen in the light of sustained and rapid growth in the largest developing economies which created an unprecedented boom in metal prices.<sup>3</sup> This boom left many mining companies, particularly the largest, cash rich. Credit, through the banking sector, moreover, was readily available. The largest companies, as they looked to quickly expand via acquisition, avoiding the lengthy time horizons required in developing new mines, initiated an unprecedented spate of mergers and acquisitions in the metal mining industries. Between 1995 and 2006 almost 20 "mega-mergers," huge deals exceeding US\$1 billion, took place.<sup>4</sup> Concentration in the metal mining industries increased significantly. By 2006 the ten largest mining companies controlled 33 per cent of the world's total non-energy minerals output, up from 26 per cent in 1995. The degree of concentration rose fastest among minerals including iron ore (from 44 to 52 per cent) and copper (from 51 to 58 per cent), resources critical for China's development.<sup>5</sup>

By late 2007, even as the global credit crisis was beginning to unfold, the merger wave reached its zenith. An endgame in the scramble for resources, involving the largest cross-border deals in history, started to play itself out. Firstly, Rio successfully bought Alcan for US\$38.6 billion. As a result Rio, as well as being a major iron ore and copper producer, became the world's largest producer of aluminium and bauxite. Then, only shortly after this huge, debt-fuelled acquisition, Rio itself became a target of BHP Billiton. At the time, BHP was the third largest producer of iron ore and second of copper globally, Rio Tinto the second and fifth. The merger, therefore, would have created the largest single producer of iron ore (with one third of the world's iron ore) and copper, as well also as aluminium and power-station coal, in the world.

At this point, there was a real danger the resources China needed for its development would become forever tied up in just a few large global companies. China's massive demand for metals such as iron, steel and copper, is driven by its breakneck economic growth. Between 1990 and 2007, for example, pig iron, crude steel and rolled steel production, increased nearly tenfold. By 2007, 15 of the top 50 steel producers in the world were Chinese.<sup>6</sup> In 1990, by contrast, there were none. China

3 World Bank, "Global economic prospects: commodities at the crossroads," in World Bank (ed.), *Global Economic Prospects* (Washington DC: World Bank, 2009), pp. 196.

4 UNCTAD, "World Investment Report 2007: Transnational Corporations, Extractive Industries and Development," World Investment Report (New York and Geneva: UNCTAD, 2007), pp. 323.

5 Ibid.

6 World Steel Association, "Top steel producers 2007," (Brussels: World Steel Association, 2009), available from <http://www.worldsteel.org/>.

now produces around half of the world's steel output. The global consolidation of the metals mining threatened to push up the costs of China's development considerably and in the worst possible case, even bring it to a halt.

In this light, China had to act. Chinalco, a Chinese national champion, became its chosen vehicle. As with China's other national champions, the group has grown through state support and the acquisition of numerous smaller domestic rivals. As a result, Chinalco has become the largest aluminium corporation in China, with monopolistic power in price-setting both downstream and upstream in its wide range of products. In February 2009, moreover, the State Council released a detailed plan in which Chinalco was selected to be among three to five groups leading domestic consolidation of the non-ferrous metals industry. A stimulus package has been created to promote this goal. Like many of China's national champion groups owned by the State-owned Assets Supervision and Administration Commission (SASAC), it has been supported in its bid to increase its profits in recent times. Yet, despite this support, its profits dropped by 99 per cent in 2008 owing to the collapse in demand for aluminium. In addition, its original 2008 investment in Rio lost 70 per cent of its market value – about US\$10 billion, and it will incur net losses this year.

Despite these losses, four of the biggest Chinese state-owned banks – two are state policy banks – lined up to lend Chinalco US\$21 billion, more than needed for its deal with Rio. These banks charged very low interest, only 94.5 basis points above the six-month London inter-bank offered rate (LIBOR) and did not set a time for Chinalco to pay back the loans. Only recently, by contrast, BHP Billiton issued ten-year bonds which had to bear interest at 390 basis points above the six-month LIBOR.<sup>7</sup> This type and scale of lending activity is possible only in China, where the state-owned banks and businesses are treated as the left and right arms of the state to achieve its national long-term development objectives.

Unsurprisingly, Chinalco's international expansion, as for many other Chinese groups, is not well explained by existing theories concerning the key motivations for foreign direct investment.<sup>8</sup> Existing theories suggest that investing firms should possess some kind of advantages over their host-country competitors, be it technology, brand or management skills. If we compare Chinalco with Rio, however, the former does not appear to have any such advantages. It is actually smaller and less profitable. If, however, Chinese policy makers are seen as using Chinalco simply as a vehicle for national security and development, the high degree of asset specificity – China's total dependence on iron ore to develop – fully explains its desire to vertically integrate with Rio.

7 Zhen Yang, "Easier loans lead to more M&As," *China Daily*, 20 April 2009, p. 4.

8 See for example R. Morck, B. Yeung and M. Zhao, "Perspectives on China's outward foreign direct investment," *Journal of International Business Studies*, Vol. 39 (2008), pp. 13, and J. Child and S. B. Rodrigues, "The internationalization of Chinese firms: A case for theoretical extension?," *Management and Organization Review*, Vol. 1, No. 3 (2005), pp. 19.

## China's National Champions Taking Advantage of the Global Financial Crisis

Chinalco's bid for Rio also illustrates a larger and arguably, more important story, concerning the international expansion of China's national champions after the financial crisis. China's policy makers, since early on in their economic reforms, have worked hard to turn around their state-owned businesses. Ultimately, they hold the long-term strategic aim of developing their own national champions into internationally competitive TNCs. China's Vice-Premier, Wu Bangguo, noted more than a decade ago:

In reality, international economic confrontations show that if a country has several large companies or groups it will be assured of maintaining a certain market share and a position in the international economic order. America, for example, relies on General Motors, Boeing, Du Pont and a batch of other multinational companies. Japan relies on six large enterprise groups, and Korea relies on 10 large commercial groupings. In the same way now and in the next century our nation's position in the international economic order will be to a large extent determined by the position of our nation's large enterprises and groups.<sup>9</sup>

Following in this spirit, a wide variety of measures have been taken, and a number of Chinese big business groups, following an East Asian model of development, have emerged. By 2008 around 150, including Chinalco, had been selected for trials. They had also grown at amazing speed, gaining privileged access to stock market listings and bank finance, among other things. Over the past decade their assets, sales and R&D expenditure grew on average at a staggering 25 per cent a year. Their profits grew even faster – at around 40 per cent a year.<sup>10</sup> As would be expected, they have led in China's internationalization efforts, accounting for 40% of the country's total OFDI in 2007, and even higher shares in previous years.<sup>11</sup> The strong state backing for overseas expansion is illustrated by the fact that China is bucking the world trend. Even as global flows of FDI have started to contract rapidly, Chinese outflows continued to rise (see Figure 1). Six years ago, direct foreign investment originating from China was negligible; by 2008, it had rocketed to US\$52 billion. Had Chinalco's deal been successful, total OFDI from China would have again doubled in 2009. Despite Chinalco's failure, this trend is likely to continue.

There are two important reasons why we can expect this. Firstly, such increases will progressively be driven by China's banks. Four of the world's ten largest banks are now Chinese, including the three largest in terms of market capitalization.<sup>12</sup> By mid-2009, interestingly, US banks had a bigger proportion of state ownership and larger debts. In December 2008 restrictions were lifted on China's banks, allowing them to lend for overseas acquisitions for the first time, and to actively support the "go global" policy. Secondly, owing to the financial crisis, China's national

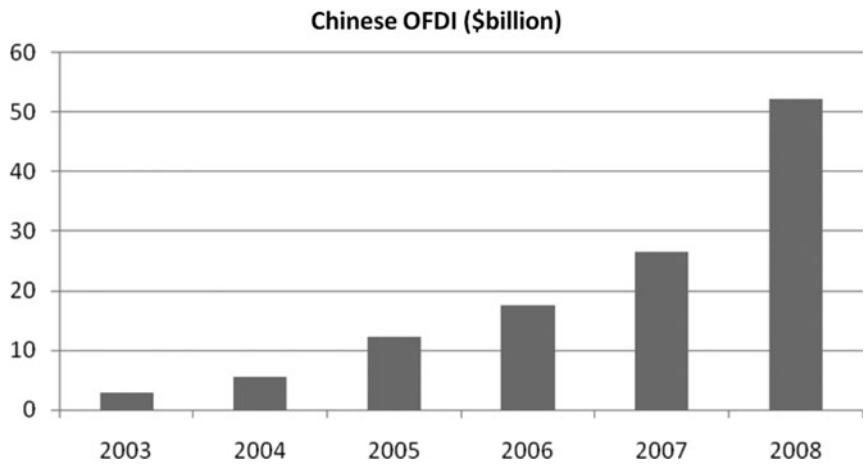
9 D. Sutherland, "Policies to build national champions: China's 'national team' of enterprise groups," in P. Nolan (ed.), *China and the Global Business Revolution* (New York: Palgrave, 2001), p. 1092.

10 SSB, *Large Corporations of China 2007*, (Beijing: China Statistics Press, 2008).

11 D. Sutherland, "Do China's "national team" business groups undertake strategic-asset-seeking OFDI?," *Chinese Management Studies*, Vol. 3, No. 1 (2009), pp. 13.

12 Lex, "No dim sum", *Financial times*, 16 March 2009, p. 24.

Figure 1: **Growth of China’s Outward Foreign Direct Investment**



Source:  
2007 *Statistical Bulletin of China’s Outward Foreign Direct Investment* (Beijing: Mofcom, 2008); Yan Zhou, “M&A prices look right to many in their plans to go global,” *China Daily*, 6 April 2009.

champions have also seen a dramatic increase in their financial size relative to their global counterparts. In 1997 China’s trial national champion groups had profits totalling only three per cent of the top 100 businesses in the Fortune 500. By 2008, however, after a record fall in those of the Fortune 500, their profits jumped to around 40 per cent.<sup>13</sup> Symbolically, by May 2009 PetroChina had become the largest company, and ICBC (Industrial and Commercial Bank of China) the largest bank in the world by market value.

Until recently, the prospects for China’s national champions were considered bleak.<sup>14</sup> The global financial crisis, however, provides an unforeseen opportunity for them. Chinalco may have lost one, albeit important, battle. There will, however, surely be more to come, as other groups attempt similar moves elsewhere, leveraging their healthier balance sheets and easier access to credit through the banking system. Minmetal’s (another of China’s national champion mining groups) US\$1.38 billion successful bid for Oz Minerals (another large Australian mining company), only one week after the breakdown of the Chinalco–Rio partnership, is just one, albeit smaller, example. Other examples may include Beijing Automobile Industry Corporation (BAIC)’s attempt for Ford’s Volvo, Geely’s interest in GM’s SAAB and Tengchong’s bid for GM’s Hummer. All this signals that it is only the beginning for China’s national champions in their long march to become truly global.

13 Fortune, “Fortune 500,” Fortune (CNN Money, 2009), SSB, *Large Corporations of China 2007*, (Beijing: State Statistical Bureau, 2009).  
14 Peter Nolan, *China and the Global Business Revolution* (New York: Palgrave, 2001), pp. 1092.

### Catch-up and China's National Champions: A Long March Cut Short?

Has Chinalco's and China's bid for Rio really ended in failure? From one perspective, it has. The complex deal (outlined in a 600-page document) was bound to be subject to a long review. As such, it opened the way for closer scrutiny and public discussion, missing the small window of opportunity that in the end turned out to be available to it. In February 2009, Chinalco had what seemed an all-powerful bargaining position. It tried, however, to push this advantage too far. It overlooked the alternative options that existed for Rio, as well as the tenacity of BHP. In the end it lost out. If it had made a straightforward equity deal, instead of the complex joint-venture arrangement and convertible bond, it may well have brokered a deal. As a result, Chinese steel makers now find themselves in an awkward and unenviable position, with mounting losses and facing even harder future negotiations – now pitted against a possible global duopoly in sea-borne iron ore. Chinalco simply failed to get the deal it wanted.

There are, however, reasons for more positive perspectives. Firstly, its initial purchase of Rio's shares, through a special vehicle formed with Alcoa in Singapore, was widely admired for blocking the massive BHP–Rio deal. Chinalco's approach showed signs of sophistication and finesse. It was, and remains, successful in scuppering this potentially, much bigger and more harmful deal. This should not be forgotten. As well as this, the fine detail of its failed bid was also cleverly designed to give it considerable strength in the marketing and negotiation of sales contracts of the iron ore produced at Rio's Pilbara mines, vital to keeping prices low to China's steel makers. This, indeed, may have been its ultimate objective. A simpler equity deal may not have been able to achieve these ends.

Secondly, Chinalco's bid failed primarily on commercial terms, not political ones.<sup>15</sup> In the end, shareholders saw more value in the BHP Pilbara joint venture, coupled with a non-dilutive rights issue. There is a very strong economic logic, given the cost savings and also market power it creates, for this joint venture. As such, it was always going to be difficult for Chinalco to achieve its ends. It must be kept in mind, however, that there is still no guarantee that competition authorities will grant the joint-venture approval. The World Steel Association, representing the interests of largest global steel companies, has already formally asked the European Competition Commission to investigate the joint-venture deal. Japanese authorities are also concerned. The initial objections to the larger Rio–BHP tie-up back in 2008 also centred, in part, on the Pilbara operations. The current reincarnation of this deal envisages merging the mining operations but maintaining two separate marketing businesses. Steel industry executives, however, have already referred to this solution as “the devil in disguise.” The Western Australian government is also concerned about the joint-ventures

15 All companies, even big foreign private companies – as China's recent rejection of Coke's bid for the famous Huiyuan juice brand shows – may face similar political obstacles.



intentions to avoid certain royalties. As such, it may still be too early to say whether Chinalco has failed in one of its initial objectives – blocking the merger of Rio and BHP's iron ore operations.

Finally, looking at the bigger picture, the Chinalco/Rio debacle demonstrates that the real prospects for China's national champions are far brighter than they were before the financial crisis. Rio only became vulnerable in the first place because of the crisis. Whereas Rio could not pay off its debts, Chinalco, by contrast, was strongly supported by China's state banks. These banks will continue to back more national champion groups in their forays overseas, as China looks to turn its monetary reserves into hard assets. It will still take a number of years for the Western banking system to recapitalize, so restricting some of the financing options for other TNCs competing for these assets. Moving to the real economy, the balance sheets of China's other national champions are now also far stronger than ever in comparison to the TNCs they hope to catch up with. China continues to grow while the developed market economies shrink. As such, an unexpected window of opportunity now presents itself. The long march for China's national champions, therefore, has not been cut short, but in fact, has only just begun.